External Stability

10

Multiple Choice

1	B	**6**	D	**11**	D	**16**	A
2	B	**7**	D	**12**	A	**17**	B
3	A	**8**	A	**13**	C	**18**	C
4	C	**9**	C	**14**	B	**19**	A
5	D	**10**	C	**15**	B	**20**	C

Short Answers

Question 1

(a) External stability refers to the aim of government economic policy that seeks to promote sustainability on the external accounts so that Australia can continue to service its financial obligations to the rest of the world. The components of external stability are maintaining a sustainable level of net foreign liabilities and current account deficit, as well as avoiding exchange rate volatility.

(b) For the last decades Australia's current account deficit (CAD) has been persistently in deficit. The CAD moves in a cyclical manner, mostly following the fluctuations in the balance on goods and services. Between 2007-08 and 2010-11 the CAD improved significantly, due to a small BOGS surplus (a result of the highest terms of trade in 140 years) as well as an improvement in the net primary income account (a result of rises in the household savings ratio because of weakened consumer confidence).

(c) The current account deficit is measured as proportion of GDP for two reasons. Firstly, is to allow for comparisons between different years. Secondly, it allows comparison between the current accounts of different nations.

(d) In the short term, a current account deficit can lead to an improvement in economic growth. This is because a high CAD indicates a high level of foreign investment in Australia. Investment in Australia, improves economic growth as it increases our productive capacity. Furthermore, if imports consist primarily of intermediary and capital goods, they can be used to improve domestic efficiency and therefore, increase output and exports. However, in the long term a current account deficit limits economic growth. This is known as the balance of payments constraint, where domestic funds are spent on interest repayments and imports. Both of these are leakages from the domestic economy and result in a reduced level of aggregate demand, reducing economic growth.

Question 2

(a) Foreign liabilities refer to Australia's financial obligations to the rest of the world, made up of foreign debt and foreign equity. Foreign debt is the total stock of loans owed by Australians to foreigners. Foreign equity is the total value of assets in Australia – such as land, shares and companies – that are in foreign ownership.

(b) Foreign liabilities are represented in both accounts. Capital inflows are represented in the financial account as a credit, either as foreign direct investment or portfolio investment. However, the repayment and servicing costs of foreign liabilities result in a debit from the net primary account in the current account. Interest is the servicing cost of foreign debt, while profits and dividends are the servicing costs on foreign equity.

(c) There are both structural and cyclical factors that cause Australia to have a high level of foreign liabilities. The most important structural factor is the savings-investment gap. Australia has a low level of national savings but a high level of domestic investment. As a result, firms must turn to foreign finance to fund domestic investment, raising Australia's level of foreign liabilities. Another important structural factor is Australia's deregulated financial market. A deregulated market ensures Australian firms can easily access foreign sources of funding. This increases our foreign liabilities. Cyclically there are a number of factors causing Australia's foreign liabilities. In recent times, a key one has been domestic economic growth. Australia has enjoyed more than two decades of continuous economic growth; this has meant that consumer spending and investment demand has risen significantly. In order to fund this, Australians have accessed overseas funds causing our foreign liabilities to increase. A second factor is our domestic interest rate. With the global economy continuing to experience poor levels of growth, overseas governments have reduced their interest rates to provide stimulus. This contrasts with the success of the continuing growth of the Australian economy, which has lead to higher interest rates. The higher interest rates in Australia have made Australia more attractive to overseas investors; this has increased our foreign liabilities.

Question 3

(a) A bilateral exchange rate measures the Australian dollar against just one other currency. A multilateral exchange rate measures the Australian dollar against more than one currency. The trade-weighted index is a multilateral exchange rate, it measures the value of the Australian dollar to a basket of currencies based on their importance to Australia's trade.

(b) The components of external stability are maintaining a stable exchange rate; ensuring a serviceable level of foreign liabilities; and a sustainable current account deficit.

(c) In recent times, the exchange rate has fallen to lows of $0.68 in July 2009 and post float highs, reaching parity with the US dollar. The exchange rate fell during the Global Financial Crisis as investors lost confidence. As Australia is a small open economy, the 'pulling out' by investors caused a dramatic depreciation. The depreciation was so harsh that the RBA intervened to reduce its impact on the domestic economy. However, since the GFC period and as Asian growth has recovered, the Australian exchange rate has consistently remained above parity. This is due to demand for our minerals which is increasing international investment, increasing demand for the Australian dollar. This causes an appreciation.

(d) A depreciation causes different effects on the different components of the current account. A depreciation results in the net primary income account worsening. This is because servicing costs of foreign liabilities now increase in Australian dollar terms. However, on the balance on goods and services the effect of a depreciation is mixed, as evidenced by the theory of the 'J-Curve'. Initially, due to price effects, a depreciation causes a deterioration in the BOGS balance. This is due to falling export prices and rising import prices. This worsens the CAD. However in the long run, the depreciation improves the BOGS position. This is because of an improvement in improvement in international competitiveness as Australian goods are now cheaper in international markets. This results in Australai selling a greater volume of exports and buying a reduced volume of imports (as they are now dearer in Australian dollar terms). The effect of this strengthens the BOGS balance improving the CAD.